Matching Outreach and Financial Sustainability

An Assessed Accounting Framework in Evaluating Performance of Microfinance Project

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Abstract— **The theoretical framework, consisting of the traditional literature on performance is contextualized according to the specific rationale that characterizes the microfinance operation. Performance evaluation, moreover, is not a new subject matter in microfinance. On the international level, different models of evaluation have been developed over the course of the last years. This work proposes an alternative performance measure for microfinance. The innovative force is inspired with respect to three specific requirements: the first is the strict derivation of the classical doctrine on performance analysis – that assures the rigorousness and reliability; its adaptability to formal institutions, including non-profit organizations that are less formal and complex; the need to find a correct balance between the two dichotomous objectives that characterize microfinance, that is the financial sustainability and outreach.**

Keywords: Microfinance, Outreach, Sustainability, Performance

I. Introduction

Performance analysis is the process of evaluating the actual results produced by a project, or by an institution in relation to the results that were expected. Because the processes and activities which make up the project or the institution are diverse, they should/can be analyzed in relation to the distinct areas of management to which they belong [1]-[2].

Therefore, the foundation of performance evaluation is the availability of data relative to *each area of management* and to the *individual operations* of each area, which form a system of indicators that offers adequate information on the whole. Performance evaluation is a process based on complementary, yet diverse information related to the operation of singular aspects of management and it is conditioned by the necessity to prepare/arrange the information that, even if it is a synopsis, it permits us to satisfy three main objectives:

- to formulate *ex-ante* realistic expectations of the available resources;
- to monitor *over time* the management's operational ability to achieve the objectives;
- to evaluate *ex-post* results achieved.

Performance sustainability over time and the achievement of objectives are based also on a process of data collection, classification, selection and organization of data. This analysis and presentation of the information used allows for the real time correction of eventual distortions, which cause deviation from the fixed objectives [3].

The data collection, classification and selection process must consider information that is relevant for the on-going monitoring of the processes and activities of each area of the operation that influences the evaluation of the performance as a whole: the act of data collection, classification and selection of data are, thus, conditions necessary for their elaboration and successive presentation as relevant information.

The presentation of the information acquired, thus, acquires an immediate, indicative/signpost value when it is reorganized in quantitative or qualitative indicators. One model of performance evaluation can, therefore, be defined as a coordinated system of processing information, which allows to evaluate each operations of the entity - be it a project or an institution - by the use of indicators.

An efficient system of evaluation must have the requisite characteristics for achieving the following objectives:

- the comparability of performance *over time*,
- the comparability of performance *in space*,
- the comparability of performance *with respect to a benchmark*.

The comparability of performance *over time* identifies how well internal management can monitor the operations of the entity by accessing a constant flow of relevant information: continued monitoring allows intervention and timely decision-making in order to avoid negative results which would influence the overall performance.

The comparability of performance *in space*, rather, is a necessary condition for informing, those other than internal management, even those who intend to compare periodic results of a project/institution with results of other projects or other institutions: the different degree of success with respect to a comparable initiative allows the evaluation of the efficacy and efficiency in terms of resources employed. In this respect, performance analysis is an important instrument for investors in decision-making.

As for the comparability of results *with respect to an industry benchmark*, the possibility to compare the results produced and measured with an integrated system of indicators that is recognized as an industry standard of performance allows a qualitative-quantitative comparison of results achieved (*actual performance*) with respect to the desired result to satisfy sustainability over time (*benchmark performance*). From this perspective, performance analysis is also a useful instrument for policy makers.

DOI: 10.5176/2010-4804_2.3.218

II. Microfinance Performance

From a business perspective, the concept of performance is strictly tied to the earnings of the business (Net Profit), which is understood to be the difference – positive or negative - derived from the comparison/juxtaposition of the proceeds produced by activities and the costs sustained for those activities computed on an accrual basis.

The perspective of profit generation has, thus, focused the analysis of the performance in terms of *profitability* and in terms of technical, operational and strategic *efficiency* of the business.

Differently from a profit-oriented business, the parameter of profit maximization, widely accepted in competitive market analysis, faces an obstacle in the world of microfinance: *outreach* [4]-[7]. If, on one hand, the conditions for achieving economic-financial balance in the initiative must be respected in order to guarantee its sustainability in the long term, then, on the other hand, due to the complex dichotomy of the fundamental goals involved, the fundamental objectives of microfinance cannot be achieved adopting the same performance indicators system currently used in capital markets: while in capital markets the degree of success of an initiative is accurately measured with indicators that signal whether the earnings expectations have been met, from a microfinance perspective the system of indicators must be integrated, and at times corrected, in order to take into consideration that:

- specific objectives of a microfinance activity - like outreach - and the degree of success is measured considering parameters different from that of earnings alone; for example: *ethical-solidarity guidelines*;
- the benchmark can always differ depending on the *specific outreach goals* of the financed project [8].

Thus, in accordance with the type of intervention required as per development politics and social and humanitarian objectives, and once the sphere of influence of the project is defined, it is also necessary to have a viable calculation which can evaluate results on the basis of a double binomial interpretation:

- the *economic-financial sustainability* of the projects and institutions in order to guarantee the regeneration of resources at the base of the microfinance process;
- the *satisfaction of institutional objectives*, reviving the concept of outreach [9].

With respect to the above-mentioned parameters, it is necessary to define a system of performance indicators that satisfy at least *two objectives*:

- *offering efficient information* to the stakeholders in the microfinance sector (donors, MFI's and investors);
- *considering the characteristics of a cycle of financing* that is different, if not alternative, to the traditional cycle.

In synthesis, from a microfinance perspective, as compared to that of a purely performance based analysis of the business, the main characteristics of performance analysis should consider that:

- there is a *trade*-off between the satisfaction of the *development goals* in the particular area of the intervention (with regard to the number and quality of the beneficiaries of microfinance - or outreach) and with the goals of *economic-financial sustainability* of the project;
- there is a *different quality of benchmark* for measuring the degree of fulfillment of the goals of the financed projects/MFIs using a methodology tailored to the informational needs of microfinance, not only in terms of profit produced but also in *ethical-solidarity objectives* achieved [10].

Thus, because of the different meaning of performance with regard to microfinance , it becomes necessary to adapt the traditional model of performance evaluation – partially redefining or adapting, using corrective mechanisms and all the associated instruments used in traditional analysis in order to account for different objectives in respect to maximization of profit.

III. Performance Evaluation Model for Microfinance Project

The management features of microfinance institutions, in particular with regard to the characteristics of the beneficiaries served and the products requested, as well as the process for distribution of credit, create *two requirements* related to the selection of a system of performance indicators:

- the need of monitoring traditional aspects of management typical of all financial institutions;
- the need to consider the influence of certain instruments and forms of financing which sustain microfinance activities in order to compare different types of institutions.

The adequacy of the system of indicators is a necessary condition for the performance analysis that can be conducted with a different width and depth according to the aspects observed and the analytical level and completeness of the requested information. In order to be considered adequate, the system of indicators must possess certain specific characteristics:

- *simplicity*: the indicators should be as easy to measure and implement as possible;
- *relevance*: the indicators should measure aspects of projects that are of particular interest and importance;

- *uniqueness*: within the set of indicators, another indicator must add significant additional information that is noteworthy or of value;
- *completeness*: to the extent possible, the set of indicators should collectively measure all the major aspects of projects of interest [11].

During the 1990's, there was a growing interest on the part of financial institutions in microfinance. As a result, several performance evaluation indicators emerged in relation to different area of management considered as the most important in order to evaluate performance for MFIs. The results achieved were diverse. In actuality, some models of evaluation were generally accepted and have been currently adopted by institutions to monitor and evaluate the business. Each of these models focused on specific profiles of analysis. These models contribute to raising the level of informative transparency with regard to the processes of credit management of MFIs. They have solved the questions about terminology and composition of the accounting items in order to better monitoring and evaluating performance of microfinance institutions [12]-[13]. Nevertheless, these models are not completely in agreement in terms of areas analyzed, and on which to concentrate the evaluation of performance [14].

The logic of a construction of a performance evaluation system is in part undermined by the numerous indicators identified in the more popular models for performance evaluation in the field of microfinance. This has in turn caused a loss of significance of the classification criteria of the same indicators formerly adopted for the distinct profiles of analysis of the MFIs [15]-[17].

Despite a lot of attention being given to the evolutionary dynamics of microfinance business, not much consideration has been dedicated to an analysis of microfinance in terms of *monitoring and evaluating single projects*.

This is particularly relevant in the case of informal and semi-formal MFI's promoting a few microfinance programs per year, thanks to public and private donations [18]-[19].

Adjusting the focus of performance analysis to a project financing approach (and not to the overall performance of an MFI), the following objectives should be achieved [20]:

- a valuation approach adapted from the traditional performance analysis model consistent with the accounting practices followed by non-formal and semi-formal MFI's;
- a set of project indicators specifically tailored to the non-formal and semi-formal MFI's financial statement.

A performance analysis of a single project should at least consider the following areas:

- *Management analysis;*
- *Cash flow analysis;*
- *Earnings analysis;*
- *Portfolio quality analysis;*
- *Outreach analysis;*
- *Subsidies dependence analysis.*

A. *Management Analysis*

The indicators for the analysis and monitoring of the management area should analyze at least:

- the cost composition;
- the productivity of the personnel employed.

Productivity and efficiency ratios can be restricted to cost composition and productivity of the personnel. The analysis of the project's productivity is geared toward and evaluation of the composition of the costs of the project, mainly personnel, consulting and training costs (Table 1).

TABLE I. COST COMPOSITION INDICATORS

Cost of personnel / Total current cost
Consulting costs / Total current cost
Cost of training / Total current cost

The analysis of the productivity of the personnel should focus on the productivity of the loan officers "*because they are the primary generators of revenue*" and on all of the personnel [21]. The recourse to external auditing must be evaluated in light of the number of personnel employed in the project (Table 2).

TABLE II. PERSONNEL PRODUCTIVITY INDICATORS

Personnel Productivity
Consulting costs / Number of personnel
Number of active borrowers / Number of personnel
Loan Officer Productivity
Number of active borrowers / Number of loan officers
Personnel Allocation
Number of loan officers / Number of personnel

B. *Cash Flow Analysis*

Performance indicators of financial analysis should be computed in relation to different areas. However, in order to avoid a large number of indicators, it's possible to limit the analysis to two specific dimensions:

- net cash flow generated by the whole project;
- cash flow generated by the outstanding portfolio connected with the microcredit activity.

These ratios are suggested in order to measure the capability of the project to generate positive net financial flows (Table 3).

TABLE III. CASH FLOW INDICATORS

Net cash flow generated by the whole project Cash inflow of the project in the period - Cash outflow of the project in the period
Net cash flow generated by the outstanding portfolio Cash inflow of the microcredit activity in the period - Cash outflow of the microcredit activity in the period

With regard to project evaluation, it could be useful to focus on the microcredit activity, especially in those cases where microcredit represents the main component of the initiative.

C. Earnings Analysis

The earnings analysis is limited to reviewing revenues and costs connected to microcredit that are relative to the disbursement and reimbursement of funds, and other microfinance activities, such as financial services provided to the beneficiaries, producing interest income and active fees for the project (Table 4).

TABLE IV. PORTFOLIO PROFITABILITY INDICATORS

Interest income / Average portfolio
Interest income + fees / Average portfolio

D. Portfolio Quality Analysis

Portfolio quality analysis is relevant because microcredit activity is the main profit generating area in a microfinance program. The set of indicators should provide information on the percentage of non-performing loans, on the guarantees and loan loss reserves available, on the effective losses to be written off (Table 5).

TABLE V. PORTFOLIO QUALITY INDICATORS

Arrears Rate Amount in arrears / Portfolio outstanding (including amounts past due)
Portfolio at Risk Outstanding balance of loans with payments past due / Portfolio outstanding (including amounts past due)
Delinquent borrower Number of delinquent borrowers / Total number of active borrowers
Repayment rate Amount received (including prepayments and past due amounts) / Amount due (excluding past due amounts)
Loan loss ratio Amount written off in the period / Average portfolio outstanding for the period guarantee
Loan collateral ratio Collaterals / Portfolio outstanding
Loan loss reserve ratio Loan loss reserve for the period / Portfolio outstanding for the period

E. Outreach Analysis

The aim of microfinance programs, which is linked to the fight against the phenomenon known as *financial exclusion* and extreme poverty, is easily classified as ethical, and it is strictly related to outreach goals. Thus, it could be useful for donors and microfinance practitioners to consider outreach indicators while evaluating the overall performance (Table 6).

In this case, outreach indicators should consider both dimensions of both breadth and depth.

TABLE VI. OUTREACH INDICATORS

Number of beneficiaries / Total portfolio outstanding
Number of women / Number of beneficiaries
Average loan amount / GNP per capita
Number of beneficiaries under poverty line / Number of beneficiaries

F. Subsidies Dependence Analysis

The ability to operate independently from subsidies can be taken as a proxy for the sustainability of the project. In particular, it is worth considering both the dependence ratio on in-kind subsidies and on financial subsidies (Table 7). In fact, subsidies of this type are usually supplied in two distinct ways: *in money subsidies*, in the form of financial participation in the project and by *in kind subsidies*, in term of technical services and infrastructures provided.

TABLE VII. SUBSIDIES DEPENDENCE INDICATORS

In-kind subsidies / Total current costs
Financial subsidies received / Total funds of the project

In summary, the performance evaluation of *individual* projects allows one to deepen the analysis to microfinance programs which are the basis of the success of the microfinance activity as a whole.

IV. Conclusions

In the field of microfinance, performance evaluation can be in reference to individual projects as well as to the microfinance institutions overall. Thus, this work focuses on a performance evaluation model for the analysis of a single project as a field not well investigated in microfinance literature.

The single project approach focuses on six main topics: *management, cash flow, earnings, portfolio quality, outreach* and *subsidies dependence*.

These topics have been chosen in strict derivation from the main problematic aspects of a project: its equilibrium is a function directly relationship to the ability of people working on it (*management* analysis), on the possibility of recovering the equilibrium of cash dynamics (*cash flow* analysis), which depends on the ability to monitor the risk-return profile of the project (*earning* and *portfolio quality* analysis) and, finally, on the opportunity to have subsidies both in-kind and money (*subsidies dependence* analysis). Only if these conditions are satisfied will the microfinance project achieve its outreach goals (*outreach* analysis).

From this perspective, a new set of indicators have been suggested. Because of the distinctive features of microfinance, in order to reach goals of sustainability and outreach, the proposed model uses accounting adjustments necessary to better realize the comparability of performance in space and over time and utilizes adjustments for subsidy, inflation, non-performing loans, foreign gains/losses.

In summary, performance analysis models should be significant tools for the evaluation of microfinance projects from a risk management perspective; they allow for an on-going monitoring of the activities and to the eventual intervention to correct and improve final performance.

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